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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 644

VALENTINE-CLARK CORPORATION,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

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INDEX

Page

Petition:

Questions presented 2
Statutes and Regulations Involved..... 2
Statement 5
Specification of errors to be urged..... 8
Reasons for granting the writ..... 9

Brief in Support of Petition:

Opinions below 14
Jurisdiction 14
Questions Presented, Statutes Involved, Etc..... 14
Argument 14

CITATIONS

Cases:

Brooklyn Life Ins. Co. v. *Dutcher*, 95 U. S. 269..... 19
Columbia River Paper Mills v. *Commissioner*, 43 B. T. A. 263..... 9
Commissioner v. *Columbia River Paper Mills* (C. C. A. 9th), 127 F. (2d) 558 12
Commissioner v. *Oswego Falls Corporation* (C. C. A. 2d), 137 F. (2d) 173 19
G. B. R. Oil Corporation v. *Commissioner*, 40 B. T. A. 738..... 16
Helms Bakeries v. *Commissioner*, 46 B. T. A. 308..... 10
Helvering v. *Northwest Steel Mills*, 311 U. S. 46..... 17
Kaufmann Department Stores Securities Corp. v. *Commissioner*, 2 T. C. 656 .....12, 16
Merchants' Exch. Bank v. *McGraw*, 59 F. 972..... 17
Northwest Bancorporation v. *Commissioner*, decided by Tax Court March 6, 1943 .....11, 12, 13
Oswego Falls Corporation v. *Commissioner*, 46 B. T. A. 801, reversed 137 F. (2d) 173 (C. C. A. 2d).....10-11, 12, 19
Paraport Theatre Leasing Corporation v. *Commissioner*, 44 B. T. A. 108 .....9-10, 11, 12, 18
Tonawanda Power Co. v. *Commissioner*, 3 B. T. A. 1195..... 17
Topliff v. *Topliff*, 122 U. S. 121..... 19
United States v. *Dakota Tractor & Equipment Co.*, 125 F. (2d) 20, certiorari denied, 316 U. S. 671.....10, 11, 12, 13, 15, 16
United States v. *Stewart*, 311 U. S. 60..... 15
Valentine-Clark Corporation v. *Commissioner*, 46 B. T. A. 821.....10, 14

Miscellaneous:

Congressional Record, Vol. 80..... 16
H. R. 12395, Sec. 15 (a), 74th Cong., 2nd Sess..... 15
Paton, Accountants' Handbook, 3d ed., p. 883..... 19
S. Rep. 1631, 77th Cong., 2nd Sess..... 16
Treasury Regulations 94, Art. 26-2 (b)..... 4

Page

Statutes:
Internal Revenue Code, c. 2, 53 Stat.:
Sec. 1118 (b) 11
Revenue Act of 1936, c. 690, 49 Stat. 1648:
Sec. 14 (a) (1) and (2) 2, 7
Sec. 14 (b) 2, 7
Sec. 26 (c) (1), (2), and (3) 2, 3, 4, 7, 8, 9, 15, 16
Sec. 27 (e) 16
Sec. 115 (f) 4
Revenue Act of 1942, c. 619, 56 Stat. 798:
Sec. 501 (a) 16

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PETITION

Valentine-Clark Corporation prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Eighth Circuit in this cause, wherein an order by that court was filed August 31, 1943, denying a petition by the petitioner for a rehearing. By order of this Court dated November 4, 1943, the time for filing this petition was extended to and including January 29, 1944.

QUESTIONS PRESENTED

1. Whether the phrase "amounts which can be distributed" in Section 26 (c) (1) of the Revenue Act of 1936 includes not only the taxpayer's assets but also the taxpayer's own shares of capital stock and evidences of indebtedness.

2. If the latter construction be correct, whether credit under said provision is to be denied where all shares of capital stock authorized by the taxpayer's charter are outstanding and where the taxpayer is a party to a contract prohibiting "withdrawals from the corporate funds."

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 14. *Surtax on Undistributed Profits.*

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * * *

(2) [as amended by Section 501 (a) (1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] The term "undistributed net income" means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g).

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum

of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

* * * * * * *

Sec. 26. *Credits of Corporations.*

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double Credit not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

Sec. 115.

* * *

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

Regulations 94, promulgated under the Revenue Act of 1936:

Art. 26-2.

(b) Prohibition on payment of dividends.—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

STATEMENT

The petitioner, a Washington corporation, is engaged in the business of treating cedar poles and other forest products. It keeps its books and files its income-tax returns on the accrual basis of accounting. (R. 16, 28, 30.) During 1935 up to December 30, 1935, its total authorized and outstanding capital stock consisted solely of 1,000 shares of common stock of the par value of $100 each, all beneficially owned by Lillian S. Clark and her daughter Grace C. Pyle. (R. 16-17, 28-29.) M. H. Sperry acted as general manager under a contract providing for an annual salary of $7,500 plus 50% of the net earnings. (R. 16, 30-31.)

In July, 1935, the petitioner was without adequate working capital. The bank with which it did business not only refused to increase its loans, but insisted on payment of indebtedness already existing, at the same time advising that it would make further loans only on two conditions: (1) that annual withdrawals for salaries of officers and for dividends be limited to $12,000; and (2) that Mr. Sperry as active manager have a personal investment at stake in the enterprise. (R. 17, 32-34, 42-43, 45, 47-48, 57.) Conferences resulted on November 18, 1935, in the signing by the petitioner, the shareholder, and Mr. Sperry of a Memorandum of Agreement. The memorandum recited first that the bank had promised to extend a $25,000 line of credit to the petitioner "upon certain conditions". It was then provided therein, among other things, that Mrs. Clark "agrees that, so long as such line of credit is made available" to the petitioner "and/or so long as any indebtedness" is owing thereunder, "she will not make or permit withdrawals from the corporate funds to herself or any members of her family by way of salaries, dividends, loans or advances in excess of $6,000 per year", and that Mr. Sperry "agrees that

so long as" the same conditions prevail "he will not draw out in cash more than $6,000 per year" under his contract of employment. The memorandum provided further that it was to become effective January 1, 1936, and that the petitioner "assents to and approves the foregoing agreements and provisions". A copy of the memorandum was delivered to the bank. (R. 17-20, 35-36, 43-44, 45-46, 58-64.)

Five days later, in order to conform with the bank's further requirement that Mr. Sperry acquire a personal investment in the enterprise, Mr. Sperry, Mrs. Clark, and Mrs. Pyle signed another Memorandum of Agreement, of which likewise a copy was supplied to the bank. This memorandum provided, among other things that Mrs. Clark and Mrs. Pyle on or before January 1, 1936, would cause the petitioner's capital structure to be revised so as to authorize the issuance of 1,500 shares of 4% preferred stock of a par value of $100 each and to reduce the number of authorized common shares to 200 without par value; that while all the preferred shares would be issued to Mrs. Clark and Mrs. Pyle, the common shares should be issued one-half to them and one-half to Mr. Sperry; that the latter's contract of employment would be terminated and he be given a new contract providing for a minimum annual salary of $6,000; and that the agreement of November 18, 1935, should be modified to the extent necessary to give effect to the provisions governing Mr. Sperry's future employment. On December 30, 1935, the terms of this second memorandum were carried out, and thereafter, until July 1, 1937, all 1,500 preferred shares were owned by Mrs. Clark and Mrs. Pyle and the common shares were owned one-half by them and one-half by Mr. Sperry. (R. 20-21, 29, 30, 36-37, 41, 44, 45-46, 64-72, 77-82.)

In reliance on the two agreements the bank opened a line of credit to the petitioner. The line was continuously available and the petitioner was continuously indebted there-

under from January 1, 1936, to June 30, 1937, inclusive. At no time during this period could the petitioner have paid its debt to the bank in full without adversely affecting its business and competitive position. (R. 21, 37-38, 41-42, 46, 49.)

In November, 1936, the petitioner orally asked permission of the bank to pay dividends and salaries in excess of the limits set by the contract of November 18, 1935. Such permission was denied as to dividends, but the bank gave approval to payment of a $2,500 bonus to Mr. Sperry and this bonus was paid. (R. 21, 38, 44, 46.) In June, 1937, the petitioner again requested the bank, at first orally and then by letter, for permission to pay dividends in excess of such limits. The bank, first orally and then by letter, gave permission to pay a dividend on its common stock of $5,000 in cash and $15,000 in the petitioner's notes on condition that the notes be subordinated to all bank loans and run for at least two years. A dividend was declared and paid as thus permitted. (R. 22, 38-39, 47, 73-76.) While no finding on the subject was made by the Tax Court (then the Board of Tax Appeals), the trial tribunal, Mr. Sperry and the bank officer in charge of the petitioner's account, the only witnesses, both testified that they understood and interpreted the contract of November 18, 1935, as prohibiting the payment not only of dividends in cash or other of the petitioner's assets, but also of dividends in the petitioner's notes. (R. 39-40, 46, 47, 48.)

In its returns for the taxable year 1936 and the taxable period ended June 30, 1937, the petitioner, for purposes of the surtax imposed by Section 14 (b) of the Revenue Act of 1936 on "undistributed net income" as defined in Section 14 (a) (2) of the Act, claimed a credit under the provisions of Section 26 (c) (1) of the Act. The credit was disallowed by the Commissioner. (R. 10-13, 28.) On review the Tax

Court sustained the Commissioner's action on the ground (R. 24) that the contract of November 18, 1935, did not prohibit "the payment of dividends in stock, taxable or otherwise". Its opinion did not refer to the fact that all authorized capital stock was outstanding.

The Circuit Court of Appeals affirmed the Tax Court on the ground that the contract "did not prohibit the payment of dividends by petitioner in any form except in cash"; that by Section 26 (c) (1) "the intention of Congress was to grant the credit claimed only when the distribution of dividends in any form taxable in the hands of the shareholders was prohibited"; that dividends in the petitioner's own shares of capital stock and in its own "bonds or long-term obligations" could have been paid; and that it was immaterial that all authorized capital stock was outstanding.

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the phrase "amounts which can be distributed" in Section 26 (c) (1) of the Revenue Act of 1936 includes amounts which, like shares of the taxpayer's own capital stock, can be distributed without depleting the taxpayer's assets.

2. The Circuit Court of Appeals erred in holding that the contractual prohibition upon "withdrawals from the corporate funds" did not include dividend-distributions of the taxpayer's own obligations.

3. The Circuit Court of Appeals erred in holding that it was immaterial that all the petitioner's authorized capital was outstanding.

4. The Circuit Court of Appeals erred in affirming the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. The principal issue relates to the construction to be placed on Section 26 (c) (1) of the Revenue Act of 1936, particularly the phrase "amounts which can be distributed". Viewed broadly, the question is whether the phrase refers only to asset-distributions or whether it includes also distributions of shares of the taxpayer's own capital stock. However, the latter interpretation, once adopted, raises further questions of interpretation, among them (a) whether the taxpayer's own shares "can" be distributed where all authorized shares are outstanding and (b) whether "amounts" includes non-taxable share-distributions as well as taxable ones. These questions have never been before this Court, and the course of the decisions in the lower courts indicates that their solution is not easy. There is need under the circumstances for a definitive interpretation by this Court.

2. The issue has been dealt with, from one angle or other and under varying facts, in more than a score of cases in the lower courts, and several cases are now pending, some of which are referred to below.

3. While it cannot be said definitely that there is at present a conflict of decisions, the decided cases indicate quite clearly considerable diffidence and uncertainty on the part of the courts, if indeed they have not been guilty of floundering.

The first statement on the subject appears to be a brief declaration made *obiter* in *Columbia River Paper Mills* v. *Commissioner*, 43 B. T. A. 263, decided January 7, 1941, stating, without more (p. 266), that the Tax Court agrees with the Commissioner that credit is not allowable if distribution of the taxpayer's own shares is not prohibited. However, the effect of this statement was limited by *Paraport*

Theatre Leasing Corporation v. *Commissioner*, 44 B. T. A. 108, decided April 8, 1941, wherein it was held (pp. 111-2) that credit is allowable even though share-distributions are not prohibited if such distributions as are authorized by the taxpayer's charter would not be taxable to the shareholders.

United States v. *Dakota Tractor & Equipment Co.*, 125 F. (2d) 20, certiorari denied, 316 U. S. 671, decided by the Circuit Court of Appeals for the Eighth Circuit on January 7, 1942, took the opposite view, though no reference was made to the *Paraport* decision. The opinion assumed (p. 26) that only share-distributions were permissible, and decided (pp. 26-67) that no credit was allowable though the taxpayer had but one authorized class of stock, which, however, was not fully issued. Shortly thereafter, on February 11, 1942, the Tax Court held in *Helms Bakeries* v. *Commissioner*, 46 B. T. A. 308, that credit was not allowable where share-distributions were not prohibited and the taxpayer had more than one class of stock authorized, none of them fully issued, the *Paraport* decision being distinguished because of this fact (p. 318).

On March 31, 1942, the Tax Court decided the present cause. *Valentine-Clark Corporation* v. *Commissioner*, 46 B. T. A. 821. It disallowed the credit on the ground (p. 828) that share-distributions were not prohibited, citing the *Helms* decision as authority. It seems fair to say that this conclusion was the result of inadvertent oversight of the fact that the taxpayer had no unissued authorized stock; while the *Paraport* case was cited for comparison, there is nothing to indicate that the Tax Court intended to overrule the holding in that case to the effect that credit will not be denied if the taxpayer is without unissued authorized stock. That the Tax Court's decision in this cause was inadvertent is quite clear from the circumstance that in another decision handed down the very same day, *Oswego Falls Corporation*

v. *Commissioner*, 46 B. T. A. 801, the Tax Court allowed the credit though share-distributions were not ~~permitted~~ prohibited inasmuch as the taxpayer was not in a position to issue shares which would have been taxable to the shareholders, the opinion stating (p. 808) that "We have consistently held that the ability or authority to pay a dividend does not preclude the allowance of the credit", citing the *Paraport* case, and stating further (p. 808) that the Tax Court could not agree with the contrary view advanced in the *Dakota* case, which had likewise been cited for comparison in the Tax Court's decision in this cause.[1]

Thereafter the Tax Court continued to adhere to the position adopted in the *Paraport* and *Oswego* cases. In *Northwest Bancorporation* v. *Commissioner*, an unreported "memorandum" decision decided March 6, 1943 (see 433 Commerce Clearing House, p. 8530, Par. 7245 (M)), it was held that the credit was allowable though share-distributions were permissible, since the taxpayer had only one authorized class of stock. The *Paraport* and *Oswego* cases were followed, the Tax Court stating again that it considered the *Dakota* decision in error. The *Northwest Bancorporation* case is now pending on appeal before the Circuit Court of Appeals for the Eighth Circuit.[2]

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[1]Notwithstanding they were both decided the same day, the Tax Court's decision in this cause and its decision in the **Oswego** case are clearly in conflict. This is probably due to the circumstance that both were "unreviewed" or one-man decisions. See Section 1118 (b) of the Internal Revenue Code. The **Oswego** decision was reversed upon appeal on the ground that the contract did not prohibit dividends in the taxpayers' own long-term obligations. 137 F. (2d) 173 (C. C. A. 2d).

[2]The taxpayer in the present cause is represented by the same counsel as the taxpayer in the **Northwest Bancorporation case.** The latter was argued before the Eighth Circuit on November 9, 1943, and it was because of the pendency of that case that application was made in this cause for extension of the time for filing a petition for certiorari. It is the taxpayer's intention in the **Northwest Bancorporation** case to ask for certiorari in the event of an adverse decision, which appears likely in view of the decision of the same court in the **Dakota** case. It was felt that both cases should be brought before this Court at one time since they present the same general issue under somewhat varying facts. Unfortunately decision in the **Northwest Bancorporation** case has been delayed longer than was anticipated.

In this state of the decisions[3] the present cause came before the same Circuit Court and was decided August 3, 1943. As already pointed out, the court interpreted the contract as permitting both obligation and share-distributions, and because of this denied the credit. In this connection it reaffirmed the correctness of its decision in the Dakota case. However, in doing so it interpreted that decision (pp. 483-484) as involving a contract permitting obligation-distributions as well as share-distributions, though the *Dakota* opinion itself assumes that only the latter were permitted and though the Tax Court decisions indicate that the Tax Court has always read the opinion as so assuming. Furthermore, it stated (p. 484) that "We are not concerned here * * * with the reasons advanced in support of" the *Dakota* decision.

Notwithstanding this doubt cast upon the soundness of that decision, when read as written, by the very court by which it was pronounced, the Tax Court a month later, on September 9, 1943, departed from the doctrine to which, except in this cause, it had theretofore consistently adhered, evidenced by the *Paraport*, *Oswego*, and *Northwest Bancorporation* decisions, and accepted the ruling of the *Dakota* decision as correct, at the same time citing the decision of which review is here sought. It did this in *Kaufmann Department Stores Securities Corp.* v. *Commissioner*, 2 T. C. 656, 669, in which only share-distributions were permitted and the taxpayer had only one class of authorized stock—precisely the same facts legally as in the *Northwest Ban-*

In the event of an adverse decision in that case, the taxpayer will promptly file an application for certiorari. It appears not improbable that the Commissioner will do likewise in the event of a decision unfavorable to him, since the consequent overruling of the **Dakota** decision makes doubt appear, and since the Tax Court has recently embraced the rule of that decision.

[3]It should be pointed out that credit was denied in **Commissioner** v. **Columbia River Paper Mills** (C. C. A. 9th), 127 F. (2d) 558, on the ground that share-distributions were not prohibited (p. 561). However, there were two classes of authorized stock, only one of which was fully issued.

corporation case and as in the *Dakota* case when read on the basis of the facts assumed in the opinion.

The result of the vagaries and shifting in the cases dealing with the issue is an increasing confusion—a condition that will be even worse if the court below should decide the *Northwest Bancorporation* case favorably to the taxpayer. Such confusion should not be permitted to continue, particularly where it relates to the meaning of a Federal taxing statute.

4. There are persuasive reasons for believing the decision below is in error. The principal ones are set out in the brief in support submitted herewith.

Wherefore it is respectfully submitted that the petition should be granted.

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January, 1944